CALIFORNIA UNEMPLOYMENT INSURANCE APPEALS BOARD
P O Box 944275
SACRAMENTO CA 94244-2750

U-ZEN INTERNATIONAL CORP
c/o DENNIS N BRAGER
Petitioner

EMPLOYMENT DEVELOPMENT DEPARTMENT
Respondent

Precedent Tax Decision No. P-T-493

OA Decision No.: 404723

DECISION

Attached is the Appeals Board decision in the above-captioned case issued by Board Panel members:

CYNTHIA K. THORNTON

ANN M. RICHARDSON

JACK D. COX

VIRGINIA STROM-MARTIN

Adopted as Precedent: October 18, 2005

Case No.: AO-111366
Petitioner: U-ZEN INTERNATIONAL

REM

ISSUE STATEMENT

Petitioner timely appealed from those portions of the decision of the administrative law judge ("the ALJ") denying the petition for reassessment for the period April 1, 1993 through September 30, 2000[1] on the basis that petitioner engaged in fraud or intent to evade the law ("fraud" or "tax fraud") [2].

The questions presented by petitioner on appeal are whether:

1. The assessment for the period April 1, 1993 through September 30, 1997 ("the earlier years") is barred by the three-year limitation of section 1132 of the Unemployment Insurance Code[3]; and

2. The penalties of 50 percent for fraud under section 1128(a) and 50 percent for failure to file information returns under section 1128(b) [4] apply to the period of the assessment.

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[1] The assessment issued by the Employment Development Department covered the period April 1, 1993 through September 30, 2000. The decision of the ALJ purported to deny the petition for reassessment, and thus to uphold the assessment, for the period January 1, 1993 through September 30, 2000. However, the assessment did not cover the period January 1, 1993 through March 31, 1993. Accordingly, we treat the decision of the administrative law judge as having upheld the assessment for the period April 1, 1993 through September 30, 2000.

[2] Petitioner did not appeal from those portions of the decision that upheld the deficiency assessment and 10 percent penalty under section 1127, although petitioner does contend that a portion of that assessment is barred by the statute of limitations.

[3] All references are to the Unemployment Insurance Code unless otherwise specified.

[4] Section 1128 was amended in 1994. Pursuant to the amendment, the existing provisions were renumbered 1128 (a) and subdivision (b) was added, creating for the first time a second 50 percent penalty. The amendment took effect on January 1, 1995. Therefore, the 50 percent penalty of subdivision (b) applied only to the portion of the assessment period that began on January 1, 1995. For purposes of this decision,

These questions raise the issue of what standard of proof applies in cases of alleged tax fraud under the Unemployment Insurance Code.

STATEMENT OF FACTS

On January 8, 2001, the Employment Development Department ("EDD" or "the Department") assessed petitioner for deficient returns from April 1, 1993 through September 30, 2000. The assessment was issued under sections 1127, 1128, and section 1128, subdivisions (a) and (b).

Petitioner, a closely held corporation, operated a Japanese restaurant in Los Angeles during the assessment period. Petitioner filed returns throughout the assessment period. The deficiency alleged in those returns was the failure to report cash wages paid to some employees.

Petitioner admitted the deficiency from October 1, 1997 through September 30, 2000 ("the last three years") and provided cash wage records. EDD used those records to calculate that portion of the deficiency to which petitioner stipulated.

Petitioner denied the deficiency for the earlier years and provided no cash wage records, so EDD relied on petitioner's federal income tax returns. Those returns showed no significant change in the ratio of reported wages to gross receipts before and after 1997. On average during 1998 and 1999, the cash wages were 17.7 percent of the gross receipts. EDD estimated the cash wages for the earlier years by applying this percentage to the gross receipts for those years. The ALJ concluded that petitioner had indeed paid cash wages during the earlier years and accepted EDD's calculations.

EDD also alleged the entire deficiency was due to fraud, as a consequence of which it included the earlier years in the assessment although they are beyond the three-year limitation of section 1132, and it added to the entire assessment a 50 percent fraud penalty under section 1128(a). Because petitioner did not file information returns for any cash wages, EDD also added a 50 percent penalty under section 1128(b). Petitioner denied any fraud.

The ALJ concluded that the entire deficiency was due to fraud so the earlier years were not time-barred and both 50 percent penalties applied. Thus the ALJ denied the petition for reassessment in its entirety. The ALJ did not articulate the

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references to section 1128 or its subdivisions will apply to both versions of the statute unless otherwise specified.

standard of proof she was applying when she weighed the evidence and concluded that petitioner's failure to report cash wages was due to fraud.

Some of petitioner's employees were immigrants who lacked work authorization papers. During the last three years, petitioner paid the undocumented workers in cash and some of its other employees partly in cash and partly by check. Petitioner's manager, who was also a shareholder, took dividend checks payable to shareholders, cashed them, and used the cash to pay the cash wages. Petitioner did not tell its bookkeeper about paying cash wages or maintaining separate records of these wages, so the bookkeeper did not include the cash wages in the returns petitioner filed with EDD or the Internal Revenue Service.

The manager knew that it was to the petitioner's advantage to pay employees in cash. As to the undocumented workers, the manager asserted that he could not fire these workers because the restaurant was not making money and it was hard to find qualified sushi chefs. Petitioner's other asserted justifications for paying cash wages during the last three years, but not earlier, included that the restaurant was getting busier, the health department demanded that the restaurant be cleaner, and workers were working longer hours and demanding more pay.

On appeal, petitioner contends that: 1) fraud was not established for the earlier years and therefore that portion of the assessment is barred by the three-year limitation of section 1132; and 2) fraud was not established for any period of the assessment and therefore the two 50 percent penalties are inapplicable.

REASONS FOR DECISION

Contributions for unemployment insurance are owed to EDD from employers for wages paid in employment (Unemp. Ins. Code, § 976) and for employment training (Unemp. Ins. Code, § 976.6).

Every employer must withhold taxes from wages paid to employees and pay the withheld taxes to EDD, as well as file a withholding report and a report of wages. (Unemp. Ins. Code, §§ 13020, 13021.) The employer is liable for the payment of the tax that is required to be deducted and withheld under section 13020. (Unemp. Ins. Code, § 13070.) An employer who has withheld such taxes must furnish each employee with a W-2 Form and must file a duplicate of that form with the Department. (Unemp. Ins. Code, § 13050.)

If the Department is not satisfied with any return or report made by any employing unit as to the amount of employer or wage earner contributions, it may compute the amount required to be paid upon the basis of facts contained in the

return or reports, or may make an estimate upon the basis of any information in its possession and make an assessment of the amount of the deficiency. If any part of the deficiency is due to negligence or intentional disregard of the law, a penalty of 10 percent of the amount of the deficiency shall be added to the assessment. (Unemp. Ins. Code, § 1127.)

If the failure of the employing unit to file a return or report within the time required, or if any part of the deficiency for which an assessment is made, is due to fraud or an intent to evade the law, a penalty of 50 percent of the amount of contributions assessed shall be added to the assessment. This penalty is in addition to the penalty provided by section 1127. (Unemp. Ins. Code, § 1128(a).)

An additional penalty of 50 percent of the amount of contributions assessed shall be added to any assessment that includes a penalty under section 1128 (a) if the employer paid wages and failed to provide the information returns required for California personal income tax withholding or for reporting payments of remuneration for services to the Internal Revenue Service. This penalty shall be in addition to any penalty under section 1127. (Unemp. Ins. Code, § 1128(b).)

Section 1132 of the Unemployment Insurance Code provides, in part:

> Except in the case of failure without good cause to file a return or report, fraud or intent to evade any provision of the code or authorized regulations, every notice of assessment shall be made within three years after the last day of the month following the close of the calendar quarter during which the contribution liability included in the assessment accrued or within three years after the deficient return or report is filed, or was due, whichever period expires the later.
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> In case of failure without good cause to file a return or report, every notice of assessment shall be made within eight years after the last day of the month following the close of the calendar quarter during which the contribution liability included in the assessment accrued.

In this case the assessment was made on January 8, 2001. Returns were filed for the entire assessment period, so the eight-year limitation is inapplicable and thus only the three-year limitation is at issue here. The period that fell within the three-year statute of limitations began on October 1, 1997.[5]

[5] Section 1132 provides that the assessment shall be made within three years after the last day of the month following the close of the calendar quarter during which the contribution accrued. In this case the statute of limitations is calculated as follows. The assessment was made on January 8, 2001; January 8, 1998 was three years before the date of issuance. January 8, 1998 was in the month following the close

In the absence of fraud, the earlier years of the assessment were beyond the three-year statute of limitations of section 1132. In cases of fraud or intent to evade any provision of the Unemployment Insurance Code or authorized regulations, there is no statutory time limit for the issuance of an assessment. (*Precedent Tax Decision* P-T-489.) Consequently, the earlier years would not be time-barred if there was fraud or intent to evade in that period.

Furthermore, the Department imposed penalties under section 1128 for the entire period of the assessment. Those penalties are applicable only in cases involving fraud or the intent to evade the law.

In sum, the disposition of all the legal issues raised on appeal ultimately turns on whether petitioner engaged in tax fraud. Petitioner contends that tax fraud must be established by clear and convincing evidence. The Department contends that tax fraud may be proved by a preponderance of the evidence. Thus, it must be decided which standard of proof applies in tax fraud cases. The question is one of first impression for this Board.

Accordingly, we look elsewhere to identify the burden of proof required to establish fraud or intent to evade the law, as those terms are used in sections 1132 and 1128. Both state and federal courts have interpreted similar terms in various analogous tax laws.

Revenue and Taxation Code section 6485 adds a penalty when a tax deficiency results from “fraud or an intent to evade this part or authorized rules and regulations.” This language is virtually identical to that found in Unemployment Insurance Code sections 1132 and 1128. The court in *Marchica v. State Board of Equalization* (1951) 107 Cal.App.2d 501 decided that fraud under that provision of the Revenue and Taxation Code was required to be established by clear and convincing evidence. The court observed that an underpayment resulting from ignorance, bad advice, honest mistake, negligence, or a misinterpretation of law did not of itself constitute fraud. Rather, “the fraud meant by the statute is actual, intentional wrongdoing, and the intent required is the specific purpose to evade a tax believed to be owed.” (Id. at p. 509.)

More recently, the Ninth Circuit Court of Appeals considered the question in the context of a bankruptcy case in which a California taxpayer had been charged

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of a quarter during which contributions accrued. (Unemp. Ins. Code, §§ 13021(a), 1110(a) & 1110(b).) The quarter immediately preceding January 1998 began on October 1, 1997 and ended December 31, 1997. Consequently, the period within the three-year statute of limitations under section 1132 began October 1, 1997.

with civil tax fraud for consistently underreporting income from business sales. In *California State Board of Equalization v. Renovizor's, Inc. (In Re Renovizor's, Inc.*) (9th Cir. 2002) 282 F.3d 1233, the court grappled at length with the fact that, after *Marchica, supra* had been decided, the California Supreme Court had ruled in *Liodas v. Sahadi* (1977) 19 Cal. 3d 278 that the standard of proof in civil fraud was preponderance of the evidence. After careful and thoughtful analysis (and an observation that the California Supreme Court declined its request to resolve the question), the Ninth Circuit interpreted the evidentiary standard required under Revenue and Taxation Code section 6485. It noted the distinction between civil fraud and civil tax fraud and concluded: "We hold that clear and convincing evidence must be shown to establish tax fraud under California law." (*In Re Renovizor's, Inc., supra,* 282 F.3d at p. 1235.) We have not found any subsequent authority which has called into question the conclusion that the *Marchica* decision sets the standard of proof for civil tax fraud in California. The similarities in language between Revenue and Taxation Code section 6485 and Unemployment Insurance Code sections 1132 and 1128 cause us to reach the same conclusion with respect to tax fraud under the Unemployment Insurance Code.

We are persuaded by the authorities cited above that the more stringent clear and convincing evidence standard is the test which applies to employment tax fraud cases under the California Unemployment Insurance Code. This is the applicable standard in cases in which a tax assessment covers a period beyond the stated limitations periods in section 1132. It also applies to the section 1128 penalties.

In this case the ALJ failed to identify the standard of proof that she applied. Accordingly, rather than attempting to apply that standard in the first instance on appeal, it is appropriate to remand the entire matter to the ALJ who heard the evidence and to direct the ALJ to apply the newly articulated standard set forth herein. (See, e.g., *In Re Renovizor's, Inc., supra,* 282 F.3d 1233.)

Having concluded that it is the Department's burden to establish by clear and convincing evidence that petitioner engaged in fraud, we now provide guidance as to the proper application of that standard.

The petitioner generally bears the burden of proof in a tax case and it is by a preponderance of the evidence. (*Isenberg v. California Employment Stabilization Commission* (1947) 30 Cal.2d 34.) The preponderance of the evidence standard is one of the three burdens of proof recognized in California. (Calif. Evid. Code,

§ 115.)[6] The other two standards are proof beyond a reasonable doubt and proof by clear and convincing evidence. The preponderance of the evidence standard is, of course, a lesser burden than proof by clear and convincing evidence. It simply requires proof that the matter in question is more likely to be true than not true. (Judicial Council of Calif. Civil Jury Instructions, No. 200; see also *Lillian F. v. Superior Court* (1984) 160 Cal.App.3d 314, 320.)

When fraud is at issue in a tax matter, the burden is on the Department to prove fraud. (See, e.g., *P-T-489; Marchica v. State Bd. of Equalization, supra,* 107 Cal.App.2d 501*; In Re Renovizor's, Inc., supra,* 282 F.3d 1233.) The standard is clear and convincing evidence. "'"Clear and convincing" evidence requires a finding of high probability.' [Citation.] Such a test requires that the evidence be '"so clear as to leave no substantial doubt"; "sufficiently strong to command the unhesitating assent of every reasonable mind."' [Citation.]" (*Lillian F. v. Superior Court*, *supra,* 160 Cal. App. 3d at p. 320.)

When considering the 50 percent penalty of Internal Revenue Code section 6653, the Ninth Circuit Court of Appeals defined the burden this way: "'fraud is intentional wrongdoing on the part of the taxpayer with the specific intent to avoid a tax known to be owing.'" (*Bradford v. Commissioner* (9th Cir. 1986) 796 F.2d 303, 307.) In another case, the court observed: "Fraud implies bad faith, intentional wrongdoing and a sinister motive. [Fn. omitted.] It is never imputed or presumed and the courts should not sustain findings of fraud upon circumstances which at the most create only suspicion." (*Davis v. Commissioner* (10th Cir. 1950) 184 F.2d 86, 87.)

Since fraud involves concealment of some kind, courts have identified certain behaviors that might signify that a taxpayer has engaged in fraud. Some courts have referred to them as "badges of fraud." In one case, these badges of fraud included "understatements of income, failure to maintain adequate records, implausible or inconsistent explanations of behavior, concealment of assets, and failure to cooperate with tax authorities." (*Alexander Shokai, Inc. v. Commissioner* (9th Cir. 1994) 34 F.3d 1480, 1487.) In another, they included the failure to file tax returns and the lack of credibility of the taxpayer's testimony. (*Laurins v. Commissioner* (9th Cir. 1989) 889 F.2d 910, 913.) The "consistent and substantial understatement of taxable income is by itself strong evidence of fraud." (*Cefalu v. Commissioner* (5th Cir. 1960) 276 F.2d 122, 129.) The maintenance of partial records and the failure to record certain sources of income

[6] Evidence Code Section 115 provides in part: "Except as otherwise provided by law, the burden of proof requires proof by a preponderance of the evidence." Such "law" includes decisional law. (*Lillian F. v. Superior Court*, *supra*, 160 Cal.App.3d. at p. 320.)

is indicative of behavior "designed to conceal the true facts concerning taxable income." (*Bryan v. Commissioner* (5th Cir. 1954) 209 F.2d 822, 828.)

Further, a fraudulent intent or intent to evade the payment of taxes may be inferred from circumstantial evidence. (*Bradford v. Commissioner, supra,* 796 F.2d 303 at p. 307.) "'Because tax fraud is rarely established by direct evidence, fraudulent intent can be inferred from circumstantial evidence.'" (*Alexander Shokai, Inc. v. Commissioner, supra,* 34 F.3d at p. 1487; see also *Laurins v. Commissioner*, *supra,* 889 F.2d 910 at p. 913; *Akland v. Commissioner* (9th Cir. 1985) 767 F.2d 618, 621.) Such evidence is acceptable, within limits. "Although the existence of fraud may be gathered from circumstances, the piling of inference upon inference hardly qualifies as the clear and convincing evidence by which fraud must be proved." (*Goldberg v. Commissioner* (5th Cir. 1956) 239 F.2d 316, 320.) Proof of fraud in one year, without more, will not sustain a finding of fraud in another year. (*Drieborg v. Commissioner* (6th Cir. 1955) 225 F.2d 216, 220.)

In certain instances, a court can look to known behavior to conclude that the taxpayer had engaged in a pattern of fraud: "Petitioners say that fraud must be established for each year where fraud is asserted. That is true. But still, a pattern of conduct over a course can be applied to its segments." (*Bahoric v. Commissioner* (9th Cir. 1966), 363 F.2d 151,154.) The court therefore held that, "[i]f some fraud for a year is found in one year, this supports a fraud penalty for the whole of the unreported income for that year." (*Id*. at p. 154.)

Consequently, in a case where tax fraud is alleged, it is the Department's burden to prove its case by clear and convincing evidence. The proof may be based on circumstantial evidence or patterns of behavior. The understatement of income, the failure to maintain records, the implausible explanations of the taxpayer, the concealment of assets or the lack of credible testimony may cause a trier of fact to infer that a taxpayer had engaged in fraud or intent to evade.

Having articulated the applicable standard of proof for tax fraud and provided guidance as to its proper application, we now set aside the appealed portions of the decision and remand to the ALJ the following issues:

1. Whether from April 1, 1993 through September 30, 1997 petitioner engaged in fraud or intent to evade the law such that:
   a) the three-year limitation of section 1132 does not apply; and
   b) the 50 percent penalties under sections 1128(a) and 1128(b) do apply; and

2. Whether from October 1, 1997 through September 30, 2000, petitioner engaged in fraud or intent to evade the law such that the 50 percent penalties under sections 1128(a) and 1128(b) apply.

The ALJ is directed to take no new evidence, but to weigh the existing evidence by applying the clear and convincing evidence standard of proof to the remanded issues, and to articulate the basis for her conclusions in accordance with the principles discussed above.

DECISION

The appealed portions of the decision of the administrative law judge are set aside and remanded to the ALJ to weigh the evidence in accordance with the principles set forth above. The ALJ shall apply the clear and convincing evidence standard of proof on the issue of tax fraud and shall issue a new decision regarding the assessment period beginning April 1, 1993 and ending September 30, 2000.[7] The hearing transcript, oral argument transcript, exhibits and other documentary evidence previously produced in the course of these proceedings shall remain a part of the record.

[7]The entire matter is returned to the ALJ. Accordingly, the issues which petitioner did not appeal will remain with the case. The ALJ must therefore include them in the final decision without deciding them anew.